

June 4, 2015

The Honorable Steve Chabot
Chairman
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Administrator Contreras-Sweet has asked me to respond to your March 25, 2015, letter regarding the indemnification issue that recently impacted the Certified Development Company (CDC) Loan Program (also known as the 504 Loan Program). We appreciate the time your staff has devoted to this issue and are pleased to inform you that the issue was resolved in a manner acceptable to the affected parties and was communicated through SBA Procedural Notice #5000-1337, issued on March 16, 2015. Notwithstanding this issue, we note that 504 loan volume has continued at a significant pace, with 13,593 loans approved in FYs 2013 and 2014 with a value of over \$9.4 billion.

In an effort to have thorough consultation and input on this issue both before and after this issue was resolved, SBA has actively sought to engage our stakeholders, including close communication with CDC's, the National Association of Development Companies (NADCO), and Congress. I have met with your staff on this issue to answer questions and explain the steps that were taken and how we got to a resolution, and I look forward to further communication as we seek to fulfill your request.

You have requested certain information to help you to understand how this issue developed, including how we arrived at a resolution. We would like to assist you in that regard. However, we have encountered serious difficulties in gathering the specific information you requested, some of which dates back more than 60 years and most of which is quite voluminous. For example, we have identified approximately 100,000 items *from just the last 2 years* that are potentially responsive to the requests numbered 1, 2, 3, and 6 in your letter. We would like the opportunity to meet with your staff to confirm certain search terms and other parameters so that we can provide the information you need in an effective and efficient manner.

With respect to your request for data on the number of loans in the 504 and Disaster Loan Programs with an unlimited indemnification provision or covenant (requests numbered 4 and 5 in your letter), we have determined that over 1,000,000 loans were approved in the timeframe specified in your letter (between 1991 and March 25, 2015, SBA approved approximately 150,000 504 loans and over 980,000 disaster loans, of which over 560,000 were secured disaster loans). Identifying how many of these loans were secured by property subject to an open-ended indemnification provision or covenant would require a manual search of each existing loan file to determine if a title report is in the file and, if so, to search the local property records to review any covenants running with the land. Given the large number of files, such a search would

adversely impact our ability to meet ongoing loan making, servicing, and liquidation needs. In addition, if a title report is not in the file, it would be necessary to order one from a title company before we could proceed with the next step. We also note that certain loan files would no longer be available if they were destroyed in compliance with the applicable record retention schedule. In light of the impediments to producing the specific information you requested, we would appreciate the opportunity to discuss with you or your staff how to narrow the request so that we can continue to provide necessary services to the small business community while still satisfying your needs.

For greater context, we would like to provide you the legal rationale for our interpretation of the indemnification issue, the various legal theories considered, and the final conclusion arrived at through inter-agency consultation. We hope this additional information will assist you and your staff in understanding our approach to resolving the open-ended indemnification issue as it applies to the 504 Loan Program.

The SBA was concerned that if the unlimited indemnification provisions affecting titleholders of 504 project collateral were not waived, the Agency would not be able to take title to the underlying property in the event of a default by the 504 loan borrower and an ensuing foreclosure action. Taking title without the benefit of a waiver of the indemnity would have meant subjecting the Agency to an open-ended indemnification provision, which we believed may have violated the Antideficiency Act (ADA). Because the ADA carries with it serious civil and criminal sanctions for violations, we would have been remiss in ignoring these consequences if we were later found to have misinterpreted the statute.

The U.S. Supreme Court, the Office of Legal Counsel at the Department of Justice, and the U.S. Comptroller General at the Government Accountability Office have established the proposition that, absent specific statutory authority, the ADA is violated by any indemnification agreement that imposes an open-ended, unrestricted liability on the Agency. In other words, if there are insufficient available appropriations, the Agency could not cover the liability, because to do so would violate the ADA's prohibition against making payments in advance of an appropriation or in excess of an appropriation.

Based on this concern, SBA approached the indemnification issue in the 504 Loan Program with an abundance of caution and took steps to avoid agreeing to open-ended indemnification provisions. In those transactions with a known unlimited and open-ended provision, the Agency worked closely with affected CDCs to resolve the issue prior to loan closing and to complete the loan transaction, typically by obtaining waivers of the provisions on behalf of SBA. While this solved the issue in most instances, in some areas of the country, however, it became difficult to obtain waivers or otherwise resolve the issue concerning these unlimited indemnification agreements. Seeking to address this difficulty, SBA consulted and engaged with industry representatives and affected CDCs to find a solution. As an interim measure, on September 24, 2014, the Agency issued SBA Procedural Notice #5000-1327: Corrected 504 Loan Closing Procedures: Waivers of Indemnification Provisions Required at Closing, to provide a nationwide interim solution while all parties continued their efforts to find a long-term solution. The notice required CDCs to obtain waivers; however, it clearly stated that loan closings could proceed if, despite its best efforts, the CDC was unable to obtain a waiver. This interim process also

required SBA to identify and track those projects where waivers could not be obtained for further consideration in the event of default and debenture purchase.

As part of our determined effort to find a long-term solution that would allow the Agency to take title to the collateral without causing an ADA violation, SBA explored whether there were sustainable alternative interpretations of the ADA's applicability to open-ended indemnifications in the 504 Loan Program, such as: (i) whether costs arising from indemnification claims were the type of projected long-term costs that are factored into the subsidy model and payable from the loan subsidy account; (ii) whether the Federal Credit Reform Act (FCRA) or section 20(a) of the Small Business Act provided exceptions to the Antideficiency Act's prohibitions; and (iii) whether the remote possibility of a claim nullified any risk of violating the Antideficiency Act. The Agency continued to consult with the CDC community, Congressional staff, and also consulted with various colleagues, including those at the Office of Management and Budget, to seek a solution that would allow loans to close while minimizing the risks to the Program and the Federal taxpayers.

At the same time, SBA redoubled its efforts on the accounting side of the issue to find a solution that would allow the agency to close 504 loans without the need for a waiver of any indemnification provisions. Through consultations with inter-agency colleagues, SBA was able to determine that the potential costs of any such indemnifications are allowable under FCRA as part of the overall loan costs and can be paid from the permanent, indefinite appropriation for credit accounts provided under FCRA. It follows that SBA would not violate the Antideficiency Act if the Agency were to take title to 504 project collateral subject to an open-ended indemnification provision. The SBA was therefore able to conclude that there are no legal impediments to taking title to property that is subject to an open-ended indemnification provision. The CDC community has embraced this conclusion as an acceptable solution, and the National Association of Development Companies commended the Agency for its diligent efforts in pressing for a resolution of the issue.

We hope that the above discussion addresses a number of your concerns. We are committed to cooperating with you and respectfully request that you afford us the opportunity to discuss how to clarify your request so that we can provide you the information you need in a way that allows us to remain focused on our mission of creating jobs through small businesses.

We appreciate your support of SBA and America's small businesses. If you and your staff have additional have any remaining questions or would like to meet on this matter, please contact Daniel Krupnick, Deputy Assistant Administrator for Congressional and Legislative Affairs, at (202) 205-6806.

Very Truly Yours,

Melvin F. Williams, Jr.
General Counsel